BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of	
Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Inter-exchange Carriers	CC Docket No. 00-256
Federal-State Joint Board on Universal Service	CC Docket No. 96-45
Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation	CC Docket No. 98-77
Prescribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers	CC Docket No. 98-166

COMMENTS OF THE PEOPLE OF THE STATE OF CALIFORNIA AND THE CALIFORNIA PUBLIC UTILITIES COMMISSION

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TABLE OF CONTENTS

COMMENTS OF THE PEOPLE OF THE STATE OF CALIFORNIA AND THE CALIFORNIA PUBLIC UTILITIES COMMISSION

SUMMARY

The Multi-Association Group (MAG) proposal is an industry response to structural changes adopted by the Telecommunications Act of 1996 (the 1996 Act) to promote competition in all markets. The proposal, applicable to rural local exchange carriers (LECs) that are currently subject to rate-of-return regulation on the federal level, would restructure interstate access charges and offer an incentive form of regulation to those carriers. The method and extent of access charge restructuring would depend on whether a rural LEC chooses incentive regulation, in which a carrier's interstate revenue requirement and existing universal service support are indexed on the basis of inflation and access line growth. The MAG proposal also would freeze jurisdictional allocation factors applicable to rural LECs and modify rules applicable to rural LECs that acquire access lines and/or exchanges. According to MAG proponents, the MAG proposal would promote universal service, encourage competition in rural areas, and ensure lower interstate long distance rates in rural areas.

The MAG proposal suffers from serious shortcomings. In these comments to the Federal Communications Commission (FCC), the People of the State of California and the California Public Utilities Commission (California) express concern regarding numerous aspects of the MAG proposal that, taken together, would increase rural LEC earnings and universal service funding significantly while shielding the rural LECs from risk and providing little incentive to operate more efficiently or invest wisely. This overly generous treatment of rural LECs would come at the expense of consumers, including the rural LECs' customers and particularly consumers in states that are net contributors to universal service funds. California estimates that

the MAG proposal could cost California consumers $120 million annually by 2006, a price that is simply too high to pay in light of the complete lack of evidence that the MAG proposal would further universal service goals or produce other public policy benefits.

The MAG proposal fails to achieve one of the crucial goals of universal service reform adopted by the FCC for price cap LECs: the structuring of universal service support on the forward-looking cost of providing basic services. Instead, and with no justification, the MAG proposal would continue to base universal service support on rural LECs' embedded cost. The MAG proposal does not even discuss the option of forward-looking costs, or whether the FCC's forward-looking cost model could be adapted reasonably for rural use. Additionally, by recovering access charge reductions through universal service funds, the MAG proposal implicitly assumes that those lost revenues solely support universal service. However, as California has pointed out previously, above-cost access charges may well include many items including the misallocation of non-access costs, subsidization of below-cost services, recovery of embedded access costs in excess of forward-looking costs, excess contribution to an incumbent LEC's shared and common costs, and/or excess profits. These components of access charges may overlap, e.g., embedded costs for access charges could help support cross-subsidization of other services. Without a detailed examination of the rates and costs of an incumbent LEC's services, it is not possible to identify and isolate all of the causes of above-cost access charges, let alone assume that they support universal service. As a result, it is improper to automatically provide for the recovery of access charge reductions through universal service funding.

The MAG proposal increases universal service funding for rural LECs based on the unsupported allegation that rural carriers face uncertainty and risk as a result of the 1996 Act, despite the fact that the statutory rural exemptions granted to these rural carriers minimize or eliminate any uncertainty or risk. MAG alleges that the cap on universal service funding has had an adverse impact on rural LECs' investment, and particularly investment in advanced services. California notes that investment in advanced services is not within the FCC's definition of universal service and is therefore not eligible for universal service support.

As another concern, the MAG proposal perpetuates the National Exchange Carrier Association (NECA) pooling system, which is an implicit form of universal service support and is funded solely by LECs, contrary to Section 254 of the 1996 Act. Further, the MAG proposal appears to restrict the portability of at least some universal service support to only those eligible telecommunications carriers that participate in the NECA pool, which would stifle competition in rural areas.

Even if the FCC decides that universal service funding for rural LECs should be based on embedded costs, that rural LECs' access charge reductions should be recovered through increased universal service funding, and that the NECA pool should be perpetuated, the manner in which MAG would achieve these goals contains a number of other serious flaws, including the following:

- The proposal removes the cap on universal service support; expands the scope of universal service funding to include special access services, new services, and new state and federal regulations: provides inflation-based and access line-based increases in existing universal service funding; and creates new Rate Averaging Support (RAS) universal service funding – while at the same time providing no evidence whatsoever that such changes are cost-based or necessary to maintain universal service.

- The MAG proposal's incentive regulation plan lacks a productivity offset to ensure that even a portion of any efficiency gains inure to the benefit of customers in the form of reduced access charge rates and/or reduced universal service funding.

- The incentive regulation plan contains an overly-generous low end adjustment that would protect a carrier from almost all risk.

- The proposal would lock in the use of universal service funding to support non-primary residential and multi-line business customers.

- The MAG proposal would allow excessive deaveraging of SLCs and universal service support, which could be used to disadvantage potential competitors.

- Merger/acquisition safeguards would be eliminated, so that excessive universal service funding could be obtained for acquired properties.

For these reasons, the FCC should reject the MAG proposal and should, instead, maintain the current caps on universal service funding to rural LECs. Further, the FCC should develop the mechanisms necessary to base support to rural LECs on forward-looking cost and should take steps to eliminate the NECA pooling system. California identifies in these comments some of the modifications that would be needed to minimize the adverse impacts of the MAG proposal if the FCC nevertheless concludes that the MAG proposal should be adopted or that any component of the proposal should be incorporated in pending proceedings.

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COMMENTS OF THE PEOPLE OF THE STATE OF CALIFORNIA AND THE CALIFORNIA PUBLIC UTILITIES COMMISSION

I. INTRODUCTION

The People of the State of California and the California Public Utilities Commission (California) respectfully submit these comments in response to the Notice of Proposed Rulemaking (NPRM), released January 5, 2001 by the Federal Communications Commission (FCC) in the above-captioned proceeding.

In its NPRM, the FCC seeks comment on a Petition for Rulemaking filed by the Multi-Association Group (MAG), a coalition of associations representing rural carriers,[1] that seeks the adoption of a proposal to reform access charges and universal service support for incumbent local exchange carriers (LECs) subject to rate of return regulation (non-price cap carriers). The FCC seeks comment on the public policy implications of the various components of the MAG proposal, particularly as they affect rural LECs' access rate structure, universal service support, current form of regulation (i.e., potential for movement from rate-of-return regulation to incentive regulation), incentive to invest in advanced services, and the acquisition of non-rural access lines.[2] The FCC also seeks comment on MAG's proposed pricing rules as they apply to interexchange carriers (IXCs).[3]

California appreciates the opportunity to comment on the MAG proposal.As discussed herein, the MAG proposal is unsupported by evidence and fails to achieve many of the crucial

[1] MAG consists of the National Rural Telecom Association, the National Telephone Cooperative Association, the Organization for the Promotion and Advancement of Small Telecommunications Companies, and the United States Telecom Association.

[2] NRPM at ¶¶ 15-22.

[3] NRPM at ¶ 23.

goals of universal service reform. As California has indicated in previous comments, any methodology for funding universal service to high cost areas, whether served by rural or non-rural carriers, should adhere to the following principles: (1) it should use forward-looking costs to determine universal service support; (2) it should narrowly target areas of actual need; (3) it should produce a federal fund that is modestly sized; and (4) it should minimize the burden on those states that are net contributors to the fund.[4] Additionally, the MAG proposal fails to eliminate the NECA pool, an inter-carrier subsidy mechanism that is no longer appropriate. Even if those aspects of the proposal were found to be acceptable, the MAG proposal has numerous other shortcomings. The MAG proposal violates the universal service requirements of Section 254 of the Telecommunications Act of 1996 (the 1996 Act), fails to advance universal service in any demonstrable way, unjustifiably increases universal service support for rural LECs, and harms consumers who are the ultimate contributors to the increased universal service funding requirements. If the FCC nevertheless concludes that the MAG proposal should be adopted, the FCC should attempt to minimize the adverse impacts of the proposal by adopting the modifications recommended herein.

II. BACKGROUND

Under current rules, rural LECs are subject to rate-of-return regulation and have two choices for filing access tariffs. They may file tariffs based on their own costs or, alternatively, they may participate in the National Exchange Carrier Association (NECA) common line and/or traffic-sensitive tariffs. MAG estimates that approximately 99.4 percent of all rural incumbent

[4] Comments of California on Joint Board Second Recommended Decision, CC Docket No. 96-45, December 23, 1998. See also, Comments on the Rural Task Force Recommendation by the People of the State of California and the California Public Utilities Commission, November 2, 2000.

LECs' rates are established through the NECA pools and tariffs. The MAG proposal would restructure access rates by shifting recovery of some loop costs from the traffic-sensitive interstate carrier common line (CCL) rate element to the non-traffic sensitive interstate subscriber line charge (SLC) subject to SLC caps comparable to those assessed by price cap carriers subject to the CALLS plan.

The MAG proposal would create two regulatory models, Paths A and B, for rural LECs, with incentive regulation available to rural LECs that elect Path A. Path A LECs subject to incentive regulation would be guaranteed annual inflation-based increases in their per-line revenue requirements and existing forms of universal service support, with no offset for increased productivity. MAG's incentive regulation plan would also include a low-end adjustment, thereby guaranteeing Path A LECs a minimum annual rate of return.

Path A LECs would be required to reduce their traffic-sensitive interstate access charges (which consist of local switching and transport elements, the transport interconnection charge, and the CCL charge, jointly referred to as the Composite Average Rate (CAR)) to an average of 1.6 cents per minute by July 1, 2003, with such reductions fully offset by increases in their SLCs and universal service funding. Inter-exchange carriers (IXCs) would be required to reduce their interstate long distance rates in order to flow through these access rate reductions to consumers.

The MAG proposal would remove existing caps on universal service funding for both Path A and Path B LECs and would increase universal service funding to reflect any expansion in supported services and to include new services and costs of new state or federal regulations. The MAG proposal also creates new universal service support, called Rate Averaging Support (RAS), which would compensate Path A LECs that are NECA pool participants for residual revenue requirements that are not recovered through interstate access charges and existing sources of universal service support. The RAS would also support a portion of Path A LECs' special access services.

Finally, the MAG proposal would modify the rules associated with mergers and acquisitions between rural LECs and price cap LECs, thereby allowing rural LECs to acquire price cap LEC lines and receive universal service support for the acquired lines at the buyer's rather than the seller's universal service support levels. If rural LECs were to merge with price cap LECs, they could choose to be regulated either as rate-of-return or price cap LECs, as opposed to the current requirement that they become price cap LECs.

In the sections that follow, California comments on the various components of the MAG proposal.

III. THE MAG PROPOSAL FAILS TO REFORM THE STRUCTURE OF UNIVERSAL SERVICE SUPPORT FOR RURAL LECS

The MAG proposal omits crucial components of universal service reform. Importantly, it makes no effort to reform the current universal service mechanism to base universal service support on forward-looking cost so as to promote efficiency among rural LECs in the provision of universal service. The MAG proposal does not even discuss the propriety of making such a change, whether the FCC's forward-looking cost model could be adapted for application to rural LECs, or the impact of such a change on rural LECs. Instead, the MAG proposal assumes that support should continue to be based on embedded cost.

The MAG proposal also assumes that above-cost interstate access charges solely support universal service even though, as California has pointed out previously, above-cost access charges may well include one or more of the following: misallocation of non-access costs, subsidization of below-cost services, recovery of embedded access costs in excess of forward-looking costs, excess contribution to an incumbent LEC's shared and common costs, and/or excess profits. These components of access charges may overlap, e.g., embedded costs for access charges could help support cross-subsidization of other services. Without a detailed examination of the rates and costs of a rural LEC's services, it is not possible to identify and isolate all of the causes of above-cost access charges, and it is improper to assume that they support universal service.

In defending the increased universal service support under the MAG proposal, MAG proponents discuss the adverse impact of capped universal service funding on rural LECs' incentives to invest in their networks, particularly in advanced services. However, neither the MAG proposal nor its proponents provide any evidence to support this allegation, even though they propose to increase universal service funding to rural LECs by 71 percent over the next five years. MAG proponents also argue that the MAG proposal would help rural LECs address the uncertainty and risk facing them as a result of the 1996 Act. MAG proponents fail to explain the basis for their claims, given the fact that the 1996 Act specifically protects rural LECs from uncertainty and risk through statutory rural exemptions from the market-opening initiatives required of non-rural LECs.

An additional, and very problematic, omission of the MAG proposal is that it fails to eliminate the NECA pooling system despite the fact that the pools violate the universal service funding requirements set forth in Section 254 of the 1996 Act. The NECA pools are an implicit form of universal service support and are funded solely by LECs, contrary to Section 254. Instead, the MAG proposal would maintain the NECA pooling mechanism and would even require competitive LECs to join the pool in order to receive at least some portion of the universal service support available to the rural LECs with which they would attempt to compete.

These structural flaws necessitate that the MAG proposal be rejected and that the FCC proceed with the development of the mechanisms necessary to base universal service support to rural LECs on forward-looking cost. The FCC should also take steps to eliminate the NECA pooling system, as needed to comply with the universal service funding requirements of the 1996 Act.[5]

IV. MANY COMPONENTS OF THE MAG PROPOSAL ARE SERIOUSLY FLAWED

In its NPRM, the FCC seeks comment on whether the MAG proposal should be adopted in its entirety, or whether certain portions of the proposal should be incorporated into pending proceedings.[6] The FCC also seeks comment on the public policy implications of various components of the MAG proposal.[7] For the reasons set forth herein, California concludes that many of the MAG proposal components are seriously flawed. California recommends a number of modifications that are needed to minimize the adverse impacts of the MAG proposal if the FCC nevertheless decides to adopt the MAG proposal or incorporate any of its components into pending proceeding.

A. Regulatory Paths for Rural LECs

The MAG proposal would create two paths for rural incumbent LECs, Path A and Path B. Each rural incumbent LEC would elect its path before the start of the plan. Carriers electing Path A would not be allowed to return to Path B. Path B carriers would have to obtain a waiver from

[5] The MAG proposal allows Path A LECs to leave the NECA pool. Because the NECA pool is incompatible with Section 254, California does not oppose allowing LECs to exit the pool if it is maintained.

[6] NPRM at ¶ 17.

[7] Id.

the FCC in order to elect Path A after the end of a transition period. In its NPRM, the FCC seeks comment on the necessity of adopting a two-path scheme to accommodate the diversity among rural LECs and whether the two-path scheme would have practical or administrative consequences.[8] The FCC also seeks comment on the likely characteristics of rural LECs that would elect Path A when compared with those that elect Path B.[9]

The two-path scheme proposed by MAG is structurally comparable to the two-path scheme adopted under the CALLS proposal, i.e., where some price cap carriers are subject to the CALLS proposal and others are not. It does not appear that the two-path scheme would have practical or administrative consequences that are more complex than those imposed by implementation of the CALLS proposal. However, as California explains in these comments, other aspects of the MAG proposal have significant adverse public policy implications.

As for the characteristics of rural LECs that are likely to elect Path A over Path B, MAG proponents anticipate that rural LECs electing Path A would be those carriers serving the majority of access lines of rural LECs subject to the plan. In contrast, the proposal anticipates that Path B LECs will be those carriers whose access lines vary significantly from year to year or are declining because of a decline in population in their serving territories. Because the Path A incentive regulation proposal appears to be a very profitable opportunity for rural LECs whose customer base is stable, California believes that the vast majority of rural LECs will find Path A attractive. Even rural LECs whose access lines vary from year to year or whose access lines are declining may elect Path A, for several reasons. First, those rural LECs may conclude that they can achieve operating efficiency gains that would make Path A more profitable than Path B.

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[8] NPRM at ¶ 17.

[9] Id.

Second, the incentive regulation plan's low-end adjustment would insulate Path A LECs from much of the risk of a decline in earnings. Third, the increased universal service funding under Path A designed to support interstate special access rates through the RAS, would further encourage even those rural LECs whose access lines are declining and/or whose access lines vary from year to year to elect Path A instead of Path B.

B. Access Charge Rate Structure

1. The Interstate SLC

Under the MAG proposal, rural LECs are required to increase their interstate SLCs for residential and single line business customers to $5.00 per month by July 1, 2001, with increases consistent with the SLC caps for CALLS carriers in subsequent years. There would be no distinction between the SLCs assessed to primary and non-primary residential access lines. SLCs for multi-line business lines would increase from the current rate of $6.00 per line to $9.20 per line by July 1, 2003. These changes will substantially increase the portion of the common line revenue requirement recovered through flat-rated charges. Federal lifeline support would be increased to offset the increase in the SLCs paid by low-income customers. In its NPRM, the FCC seeks comment on the propriety of increasing rural LECs' interstate SLCs and whether continued maintenance of lower SLCs for rural LECs than for non-rural LECs is consistent with Section 254 of the 1996 Act.[10]

California notes that, in approving CALLS' proposed SLC increases, the FCC will allow each price cap LEC to increase its residential SLCs above $5.00 only upon a showing, supported by forward-looking cost information, that such increases are warranted. A similar showing

[10] NPRM at ¶ 17.

should be required of both Path A and Path B LECs under the MAG proposal.

Under the MAG proposal, rural LECs would be authorized to deaverage their SLCs, i.e., voluntarily reduce their SLCs below the authorized levels, in up to three geographic zones per wire center, although they would not be allowed to raise SLCs in other geographic zones within the wire center to offset the voluntary reduction. The lowest multi-line business SLC would not be allowed to decline below the lowest residential SLC in a given wire center. If rural LECs that are NECA pool participants voluntarily deaverage their SLCs, NECA would assume, in developing their revenue requirement, that they have charged the full SLC (i.e., NECA would disregard the revenue impact of the voluntary SLC reduction).

California urges the FCC not to allow rural LECs to deaverage residential and/or business SLCs. It is unclear why rural LECs would volunteer to reduce their SLCs below the capped amount. Even if rural LECs were to decide to forego SLC revenues, that reduction in revenues is more appropriately effectuated through a reduction in their universal service receipts first, and then through reductions in above-cost traffic-sensitive access charges. A movement to cost-based pricing suggests that subsidies, whether implicit or explicit, should be reduced before any voluntary reductions to the SLC are permitted.

California also opposes MAG's proposal to allow multi-line business SLCs to decline to the level of the lowest residential SLC in a wire center. It would run counter to the promotion of universal service to assess residential and single-line business customers SLCs that are higher than those assessed to multi-line business customers. At a minimum, the multi-line business SLC should be allowed to decline no lower than the *highest* residential SLC in a wire-center.

2. The CAR

The MAG proposal provides that the CAR for pooling Path A LECs would be phased down to 1.6 cents per minute on average by July 1, 2003, compared to the existing composite pooled access rate of 4.3 cents per minute. Path A pooled switched access rates would be adjusted to meet this target composite rate. MAG states that its proposed CAR reduction would reflect a percentage reduction in the per-minute switched access rates of Path A LECs comparable to that of the CALLS proposal. Path B LECs and non-pooling Path A LECs would not be required to make comparable modifications to their per-minute switched access rates.

The proposed reductions in traffic-sensitive switched access rates are advantageous in that they move access charges closer to those of non-rural carriers. However, California is concerned about the provision for automatic recovery of those reductions through the SLC and the RAS. In contrast, in adopting the CALLS plan, the FCC required up-front rate reductions and that the price cap LECs target productivity reductions to their traffic-sensitive access charge rate elements. As discussed elsewhere in these comments, the FCC should require productivity-related reductions as part of any move to incentive regulation for rural LECs, which could be focused on achieving rate restructuring such as the proposed CAR reductions.

3. Special Access Services

The MAG proposal would allow NECA to tariff special access services for Path A and Path B LECs. NECA would have broad pricing flexibility, including the ability to price new access services at "prevailing market rates." For pooling Path A LECs subject to incentive regulation, the RAS would recover the difference between special access revenue requirements and revenues. Path A and Path B LECs would also have the flexibility to develop their own price structures and tariff special access services outside the NECA pool.

Given the rural carrier exemption set forth in Section 251(f) of the 1996 Act and the accompanying lack of competition in areas served by rural LECs, it is unclear what a "prevailing" market rate would be for new access services in those monopoly markets. This aspect of the MAG proposal needs to be clarified. In addition, MAG's proposal to allow NECA to set special access services below cost, with the difference funded through the RAS, is of great concern. As discussed later in these comments, absent a determination by the FCC that special access services are a component of universal services, such subsidies are inappropriate.

C. Universal Service Support

MAG estimates that its proposal would increase total universal service funding requirements as of July 1, 2001 from $1.53 billion (status quo) to $2.22 billion (MAG), representing a $690 million or 45 percent increase. By July 21, 2006, the funding requirements would increase from $1.68 billion (status quo) to $2.88 billion (MAG), a $1.2 billion or 71 percent increase.[11] These amounts do not include the additional Lifeline support that will be needed to offset SLC increases for low income customers.

These large increases in universal service funding under the MAG proposal are excessive, unjustified, and unreasonably burdensome for the ratepayers of states that are net contributors to universal service funding. California ratepayers alone would likely be required to contribute an additional $69 million in 2001, and $120 million in 2006 to support the MAG proposal,[12] plus its share of the additional Lifeline support that will be needed.

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[11] MAG ex parte letter estimating the quantitative effects of the MAG proposal, December 8, 2000.

[12] This computation is based on the fact that California's net contributions to federal universal service funds amount to approximately 10% of those funds.

1. Increases in Current Federal Support Mechanisms

Much of the projected increase in universal service funding results from changing the current components of the federal support mechanisms. First, for both Path A and Path B LECs, the proposal would immediately remove the cap on High Cost Loop support and the corporate operations expense limitation. It has been estimated that removal of this cap would increase High Cost Loop support by about $118.5 million, based on October 1, 1999 data.[13] This proposal to remove the High Cost Loop cap, however, is not accompanied by any cost studies or other evidence indicating that removal of the cap is needed. Nor has any evidence been presented that suggests that the cap has adversely affected investment or that its removal would promote prudent investment by rural LECs.

Second, when a Path A LEC becomes subject to incentive regulation, the plan bases High Cost Loop support, Long Term Support, and Local Switching Support levels on per-line levels received in the year prior to incentive regulation, indexed by inflation and the growth in access lines. This provision automatically increases the universal service fund each year with no consideration of whether the growing amount of universal service support is needed. If a company becomes more efficient, its costs may not escalate and the universal service support increases would present an unwarranted windfall at the expense of consumers elsewhere in the country.

Third, support is subject to adjustment if the definition of supported services changes, if "the Commission or Congress acts to stimulate the deployment of new services," and for the costs of complying with new state or federal regulations.[14] The costs of new services and of

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[13] *See* RTF Recommendation at 24, ftn. 46 (this figure does not appear to include Puerto Rico)

[14] MAG proposed rules, Section 54.321(a).

complying with governmental regulations, however, are not within the definition of universal service and should not be recovered from a universal service fund. And if the FCC decides to allow recovery of such costs, the rule should be written to remove costs of any regulations that are rescinded.

2. Rate Averaging Support

Universal service funding through the RAS would be provided for Path A pooling LECs, with several components: a common line component consisting of the difference between the NECA pool's projected common line revenue requirements for Path A pooling LECs and the sum of those LECs' SLC, CCL charges, and Long Term Support, which would be distributed only to pooling Path A LECs subject to incentive regulation; a traffic sensitive component consisting of the difference between the NECA pool's projected traffic sensitive switched revenue requirement and the sum of Path A LECs' traffic-sensitive CAR rates and Local Switching Support, distributed among pooling Path A LECs; and a special access component consisting of the difference between projected special access revenue requirement and revenues for Path A pooling LECs subject to incentive regulation.[15] After June 30, 2006, NECA adjustments to bring Path A incentive LEC settlements and revenues into balance will be included in the RAS. In its NPRM, the FCC seeks comment on whether RAS funding should be extended to Path B LECs and whether RAS funding should be allowed for special access services, which have not been included in the FCC's definition of universal service.[16]

California opposes MAG's proposal to utilize universal service funding through the RAS

[15] MAG proponents explain that this component would preclude rate shock that could result from study areas increasing special access rates and would help ensure that LECs have the incentive to deploy advanced services.

[16] NPRM at ¶ 18.

for purposes unrelated to universal service, including the preservation of pooling Path A LECs' switched access revenues and the support of special access rates. Such subsidies go far beyond the purpose for universal service funding (i.e., ensuring affordable basic service), and would unnecessarily inflate the amount of universal service support that contributing states, and their consumers, are called upon to provide to rural LECs. Similarly, MAG's proposal to utilize universal service funding, through the RAS, to bring pooling Path A LECs' settlements and revenues into balance is beyond the scope of universal service funding. Any such revenue shortfalls should be recovered, if at all, from access rates and not the universal service fund. For these reasons, California opposes the creation of the RAS for pooling Path A LECs. Further, there would be no basis to extend RAS funding to Path B LECs.

In its NPRM, the FCC correctly points out that the MAG proposal does not place a ceiling on the proposed new access subsidy.[17] The FCC seeks comment on whether it would be appropriate to cap interstate access support for price cap carriers but not for non-price cap carriers.[18] As discussed above, the RAS should not be created. However, if the FCC nevertheless concludes that RAS funding is appropriate, the FCC should cap such funding based on a reasonable estimate of the gap between a rural LEC's forward-looking cost of providing basic service and the revenues, including the SLC, basic line rates, and current universal service funding, currently received by that rural LEC for the purpose of funding basic service.

3. Deaveraging Universal Service Support

The MAG proposal allows universal service support to be deaveraged in up to three geographic areas per wire center provided that deaveraging does not increase overall support to

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[17] Id.

[18] Id.

the study area. Cost support data is not required. And unlike the CALLS plan, which allowed for deaveraging in up to four geographic areas within a study area (as opposed to wire center) and only when UNE rates were deaveraged to this level, the MAG proposal contains no such conditions.

It is unclear why universal service support would be deaveraged for rural LECs since they are exempt from the market opening requirements of the 1996 Act. Even if the rural exemption were removed, deaveraging universal service support without deaveraging UNE rates in the same geographic area could adversely affect competition by allowing the incumbent LEC to minimize universal service support in areas potentially subject to competition. Such an outcome is inappropriate. Rural carriers should be allowed to deaverage universal service support only on a cost basis and only to the extent that UNE rates are deaveraged.

4. Portability of Universal Service Support

Under the MAG proposal, it appears that Long Term Support (loop cost support for NECA pool carriers) would be portable to eligible telecommunications carriers only if they participate in the NECA pool.[19] While the proposed rules specify the portability of Long Term Support, they do not explicitly address the conditions for portability of other universal service funding, i.e., the High Cost Fund, Local Switching Support, or the RAS. The MAG petition states that universal service support is portable to eligible telecommunications carriers[20] but does not specify whether availability would be dependent on the competitive LEC participating in the NECA pool.

[19] MAG proposed rules, Section 54.303(a).

[20] MAG Petition, at 5 and 12, Exhibit 1 at 17.

Regardless of whether the incumbent LEC participates in the NECA pool, the FCC should not adopt a requirement that competitive LECs must join the NECA pool in order to receive Long Term Support or any other component of universal service support. While such a requirement would help ensure that competition does not erode the number of lines from which pooled interstate access revenues are generated, it would, at the same time, significantly reduce the benefits of competition to consumers because it would prohibit competitors from charging rates different than the incumbent LEC's. Competitive LECs would, instead, be expected to charge NECA pool rates. Competitive LECs that wish to charge their own rates would be required to exit the NECA pool and forego universal service support, thereby placing the incumbent LEC with which they compete at a competitive advantage. Indeed, a rural incumbent LEC's decision to participate in the pool would effectively stave off competition that might otherwise develop.

Further, a requirement that competitive LECs must participate in the NECA pool in order to receive portable universal service support would run counter to the requirements of Section 254 of the 1996 Act. Section 254 specifies the eligibility criteria that a carrier must satisfy in order to become an eligible telecommunications carriers, and joining the NECA pool is not one of those criteria.

5. Recovery of Universal Service Contributions Through a Separate Rate Element or Line Item

In its NPRM, the FCC seeks comment on whether it should adopt a provision similar to that included in the CALLS Order for recovery of universal service contributions through a separate rate element or line item.[21] Regardless of whether a separate rate element or line item is

[21] NPRM at ¶ 18.

used, any per line or percentage assessment on end users should be reevaluated every year to ensure that rural LECs do not over-recover contributions to the fund.

D. Incentive Regulation for Path A Carriers

Once subject to incentive regulation, Path A LECs would change the way in which their interstate revenue requirement is determined. A Path A LEC's interstate revenue requirements would be based on an initial cost-based interstate revenue per line (RPL) that is adjusted (i.e., increased) annually at the rate of inflation. Total interstate revenue requirements would then be calculated as the adjusted RPL multiplied by the current number of access lines. The interstate revenue requirements would also be adjusted for additional factors including new state and federal requirements, such as those regarding implementation of the market opening requirements of the 1996 Act. Carriers would no longer be required to file cost studies or report cost annually.

The incentive regulation plan for Path A LECs would include a low-end adjustment in the event that the Path A LECs' rate of return declined below a predetermined level: 10.75% for pooling Path A LECs with five or fewer study areas, and 10.25% for all other Path A LECs, i.e., all non-pooling Path A LECs and pooling Path A LECs with more than five study areas.

In its NPRM, the FCC seeks comment on whether the MAG incentive regulation plan would promote operating efficiency, long-term investment, and investment in high-speed infrastructure among Path A incentive regulated rural LECs.[22] The FCC also seeks comment on the manner in which consumers would benefit from any of the efficiency gains that incentive-based regulation is expected to produce and whether a productivity-offset factor should be

[22] Id. at ¶ 19.

incorporated into MAG's incentive regulation plan.[23] In addition, the FCC seeks comment on the manner in which it would be evaluate the validity of low-end adjustment showings if carriers are no longer required to report cost data annually.[24]

In California's assessment, the absence of a productivity adjustment is a serious flaw in MAG's incentive regulation plan. The MAG proposal provides no mechanism by which any portion of a Path A LECs' productivity and efficiency gains can ever be passed on to consumers through a reduction in access rates and/or universal service funding. Instead, the incentive regulation plan solely benefits the LECs by allowing them to reduce their cost, keep increased earnings, and further increase their earnings through guaranteed annual increases in interstate access rates and universal service funding at the rate of inflation.

California notes that the formulas implicit in the MAG proposal, in which the RPL and per-line universal service support are increased by the rate of inflation and exogenous-type costs, are very different than the price cap formula by which a price cap index is maintained. As a result, the level of productivity adjustments that would be appropriate if the general MAG structure is adopted may be quite different than the productivity adjustments used in the price cap formula. However, there is no reason to believe, and MAG has produced no evidence to conclude, that rural LECs' costs will reasonably increase in proportion to inflation and the number of access lines served, or that universal service funding should increase by such amounts. If the FCC concludes that the MAG approach to incentive regulation should be adopted, it should require that a productivity adjustment be incorporated and should initiate a proceeding to determine the appropriate magnitude of such an adjustment.

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[23] Id. at ¶¶ 19-20.

[24] Id. at ¶ 20.

Because MAG's incentive regulation plan would cap the SLC and traffic-sensitive rates for Path A LECs that elect incentive regulation, the guaranteed annual increases in their interstate access revenue requirements would be achieved through increased universal service funding. The resulting harm would be spread to long distance customers nationwide. Of additional concern, the fact that the initial RPL is based on costs and investments incurred in a single year prior to the move to incentive regulation provides a perverse incentive for a rural LEC to inflate investments and expenses in that year, in order to lock in an unreasonably high RPL as the basis for future years' incentive-based funding. If the FCC adopts an incentive mechanism utilizing an RPL, California suggests that the RPL be based on the average of at least three years' costs, to reduce the opportunity for manipulation.

The generous low-end adjustment in MAG's incentive regulation plan raises several concerns. First, it will encourage rural LECs to carry out unnecessarily risky investments because they would be assured a minimum rate of return and, under incentive regulation, no prudence review. Should such investments succeed, the rural LEC would be able to retain all financial rewards with very minimal risk. Inclusion of a low-end adjustment would also discourage LECs from operating more efficiently and encourage them to gold plate their networks. Similar to the RPL calculation, the fact that the low-end adjustment is based on a single year's earnings creates an incentive to manipulate the timing of expenditures and investments, i.e., make "lumpy" investments and expenditures in order to invoke the low-end adjustment periodically. Further, as the FCC correctly points out, because Path A LECs that elect incentive regulation are no longer required to maintain and submit cost information, it would be impossible to assess the reasonableness of their requests for low-end adjustments. Additionally, the low-end adjustment makes the incentive plan asymmetrical, since there is no earnings sharing or other requirement that would allow customers to benefit if a Path A LEC's earnings are extraordinarily high.

Finally, the low-end adjustment would be triggered at too high a level of return, particularly for pooling Path A LECs with five or fewer study areas. The low-end adjustment would be triggered at 10.75% for such LECs and at 10.25% for non-pooling Path A LECs and for pooling Path A LECs with more than five study areas.[25] Triggering a low-end adjustment at such high levels of return would insulate LECs from risk and would maintain earnings through universal service funding to the detriment of IXCs and, ultimately, long distance consumers nationwide.

For these reasons, the MAG incentive regulation plan should contain no low-end adjustment, particularly if no productivity adjustment and no earnings sharing are required. In the alternative, the low-end adjustment should be based on at least three years' earnings levels and/or should be triggered at a level significantly lower than MAG's proposed rate of return levels.

E. Mergers and Acquisitions

The MAG proposal would eliminate the rule freezing study area boundaries for non-price cap carriers. Instead, non-price cap carriers would only need to notify the FCC and the affected state regulatory commission before incorporating acquired telephone exchanges or lines into existing study areas. The proposal would eliminate the all-or-nothing rule which requires a carrier to choose between price cap and non-price cap status. Under the MAG proposal, carriers

[25] The FCC's early price cap mechanism allowed a low-end adjustment set at 10.25% for price cap LECs that accepted earnings sharing. Price cap LECs could also choose a mechanism with no low-end adjustment and no earnings sharing. Under the MAG proposal, price cap LECs would enjoy a low-end adjustment without any similar earnings sharing requirement.

may retain non-price cap status when they become affiliated with price cap carriers, or acquire lines, exchanges, or study areas from price cap carriers.[26] In addition, the proposal would eliminate the rule that limits the level of universal service support for acquired telephone exchanges to the support that had been received by the seller.

In its NPRM, the FCC seeks comment on whether modification of the mergers and acquisitions rules, as proposed by MAG, should be adopted.[27] The FCC also seeks comment on whether the concerns that drove it to adopt these rules are adequately addressed by the MAG proposal and on whether there are alternative ways to address MAG's underlying concern that limits on universal service funding discourage rural LECs from acquiring and upgrading telephone exchanges.[28]

California opposes elimination of the merger and acquisition safeguards currently in place. Elimination of those rules would encourage price cap LECs to sell their more rural exchanges at a premium to rural carriers. Rural carriers would, in turn, be assured that their newly acquired exchanges would receive increased universal service support. This outcome would inappropriately increase the federal universal service fund. Rural carriers would be assured that their regulatory framework would not change, regardless of their newly increased size.

The MAG proposal could also encourage pooling Path A LECs to purchase low cost exchanges, because they would benefit from a windfall for the first 18 months of ownership. Under the MAG proposal, exchanges that are acquired by pooling Path A LECs, regardless of

[26] For Path A LECs, the MAG proposal also provides for adjustments to incentive-based RPL pool settlements when Path A LECs with study areas in the pool acquire lines, exchanges or study areas.

[27] NPRM at ¶ 22.

[28] Id.

the cost associated with serving those lines, would receive revenues and universal service funding for the first 18 months based on the average RPL and average per-line universal service receipts of all pooling Path A LECs. Thus, the lower the cost of serving the acquired exchanges, the greater the windfall during the initial 18 months of ownership. Such windfalls would be funded by increased universal service support and are clearly inappropriate.

For these reasons, California recommends that the FCC reject the MAG modifications to existing mergers and acquisitions safeguards.

F. Long Distance Rates

The MAG proposal mandates that IXCs offer customers in rural and high cost areas the same optional calling plans available in urban areas and requires that IXCs pass through to long distance customers the savings from lower access rates charged by rural LECs. The FCC seeks comment on these issues, including how it would ensure that IXCs comply with a pass through requirement given the fact that the FCC does not regulate the rates of IXCs.[29]

California recommends that the FCC require IXCs to demonstrate that they have flowed through access charge reductions to both business and residence customers, consistent with comments California filed previously regarding the CALLS proposal.[30] While the FCC no longer regulates the rates of IXCs directly, general requirements of this nature are appropriate to help ensure that long distance customers receive the benefit of access charge reductions.

[29] Id.

[30] Supplemental Comments of the People of the State of California and the California Public Utilities Commission, CC Docket No. 96-262, et al., April 3, 2000.

G. Jurisdictional Issues

Under the MAG proposal, separations factors for all NECA pool members would be frozen consistent with the Joint Board's Recommended Decision in CC Docket No. 80-286. As fully explained in our comments of September 26, 2000 regarding the Joint Board's Recommended Decision, attached hereto, California strongly opposes this aspect of the MAG proposal, which could result in additional rate increases to intrastate ratepayers.

V. CONCLUSION

California recommends that the FCC reject the MAG proposal and initiate steps to base rural universal service support on forward-looking cost. In order to make universal service support explicit and competitively neutral, the FCC should also eliminate the NECA pooling system. If the FCC nevertheless concludes that aspects of the MAG proposal have merit, California urges that the FCC at a minimum adopt the following modifications:

- Continuation of the cap on universal service funding.
- Exclusion from universal service funding of special access services, regulatory obligations, non-primary residential and business lines, and any other services and costs not associated with the cost of providing universal service.
- Inclusion of a productivity adjustment in the incentive regulation mechanism.
- Elimination of the low-end adjustment, particularly if no productivity adjustment or earnings sharing is included the incentive regulation mechanism.
- Denial of the RAS universal service support element for Path A LECs.
- Rejection of the proposal that rural LECs be allowed to voluntarily deaverage SLCs.
- Approval of the deaveraging of universal service support only to the extent consistent with the deaveraging of UNE rates in the same areas.
- Rejection of the proposal that competitive LECs participate in the NECA pool as a condition of receipt of universal service support.
- Maintenance of current federal rules governing mergers and acquisitions by non-price cap carriers.

- Rejection of the proposal to freeze jurisdictional separations factors for NECA pool members.

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February 26, 2001

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document "**COMMENTS OF THE PEOPLE OF THE STATE OF CALIFORNIA AND THE CALIFORNIA PUBLIC UTILITIES COMMISSION**" upon all known parties of record by mailing, by first-class mail, a copy thereof properly addressed to each party.

Dated at San Francisco, California, this 26th day of February 2001.

/s/ REBECCA ROJO
Rebecca Rojo